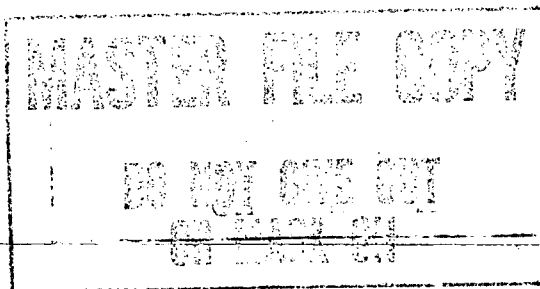




**Directorate of  
Intelligence**

**Secret**

25X1



# Malaysia: Economic Policy at the Crossroads

25X1

**An Intelligence Assessment**

~~Secret~~

EA 83-10111  
June 1983

Copy **314**

**Page Denied**



**Directorate of  
Intelligence**

**Secret**

25X1

# Malaysia: Economic Policy at the Crossroads



25X1

**An Intelligence Assessment**

This paper was prepared by [redacted] Office  
of East Asian Analysis. It was coordinated with the  
National Intelligence Council, [redacted]

25X1

25X1

Comments and queries are welcome and may be  
directed to the Chief, Southeast Asia Division, OEA,  
[redacted]

25X1

**Secret**

*EA 83-10111  
June 1983*

Secret

25X1

**Malaysia:  
Economic Policy  
at the Crossroads**

25X1

**Key Judgments**

*Information available  
as of 20 May 1983  
was used in this reports.*

Faced with a reduction in the long-term growth of primary commodity earnings during the 1980s, Malaysia is beginning to implement a new economic growth strategy. Prime Minister Mahathir's approach relies on an inward-looking heavy industrial policy based on import substitution, tariffs to protect domestic industry, and an expanded role for the government. The Prime Minister is also stressing the need to "Look East" to Japan and South Korea for a development model and touting "Malaysia, Incorporated" as part of the country's development strategy.

25X1

We believe that the new policy will fall short of its goal of rapidly propelling Malaysia into the ranks of the newly industrializing countries; Malaysia does not have a competitive advantage in heavy industry. Recognizing this, Malaysians themselves have begun to debate the wisdom of Mahathir's approach, but the Prime Minister shows little inclination to reconsider his plans. Should the new policy continue, the government risks squandering a large share of Malaysia's natural resource wealth, undermining the long-term health of its balance of payments, and stifling private investment initiative in sectors such as light manufacturing where Malaysia would otherwise do well.

25X1

Kuala Lumpur has some breathing room before its heavy industry program inflicts lasting damage on the economy. The foreign debt burden is light, and the energy sector has reasonably bright prospects. But the halcyon days of effortless trade surpluses are probably over, and this promises to keep the domestic policy debate alive. Over the next several years, warning signs such as a drop in private investment, continued growth of the foreign debt, and low-capacity utilization in Malaysia's showcase heavy industry projects would indicate that Mahathir's course is not viable, making the Prime Minister even more critical of the international commodity, foreign trade, and investment policies of the United States.

25X1

Secret

EA 83-10111  
June 1983

Secret

25X1

---

*Mahathir assumed the post of Prime Minister in 1981 when Hussein Onn retired because of poor health. He differs from his predecessors in several ways:*

- *A physician, he is the first Prime Minister who is not a lawyer.*
- *He is the first Prime Minister who did not come from a local aristocracy.*
- *He was educated in Southeast Asia, not Britain, receiving his medical degree in Singapore in 1953.*
- *He is quick tempered and outspoken, with a complex personality that makes it difficult for his countrymen to develop genuine affection for him.*



Prime Minister Mohamad Mahathir

*Mahathir, nonetheless, has created a strongly favorable impression on the electorate during his first two years in office. He runs the government under a resounding mandate he secured in the April 1982 national elections. The ruling National Front—a coalition of 11 ethnically diverse parties—won 132 of 154 national assembly seats, achieving a victory that, according to press reports, surprised even Mahathir's most devoted followers. Mahathir has moved since to undercut his opposition on the fringes of the political spectrum—Muslim fundamentalists on the right and elements of the Chinese community and poorer Malays on the left—maintaining an orderly political arena and a continuing mandate to manage the economy as he wishes.*

---

25X1

25X1

25X1  
25X1

Secret

Secret

25X1

**Malaysia:  
Economic Policy  
at the Crossroads**

25X1

**A Look Back**

Prime Minister Mahathir Mohamad in 1981 inherited an economy that has long been one of Southeast Asia's star performers. Economic growth posted a robust 8-percent annual average during the 1970s, while a strong currency kept inflation to a modest 4.7 percent a year. Government revenues, based largely on taxes on international trade and oil, proved so bountiful that the Ministry of Finance was hard pressed each year to spend budget allocations. Furthermore, rapid growth was accompanied by merchandise trade surpluses and a strong balance of payments.

The growth of manufacturing, which has averaged nearly 20 percent annually since the mid-1960s, has been even more impressive. Kuala Lumpur has long counted on the manufacturing sector—mostly semiconductor, textile, and food processing industries—to generate employment for a young and rapidly growing labor force. The manufacturing-oriented growth strategy also succeeded in dramatically restructuring the economy; the share of output generated by resource-based activities dropped from one-half of GNP in the early 1970s to about one-fourth in 1980.

Although there are many parallels between Malaysia and the recognized newly industrializing countries (NICs), such as Taiwan and South Korea, there are some important differences. In some sectors of the Malaysian economy, manufacturing growth has been associated with inward-looking import-substitution industries sustained by rising tariffs. More important, manufacturing competitiveness is undermined to some extent by raw material export earnings that push up the exchange rate. Most export manufacturing growth thus has been confined to free trade zones, where linkages to the rest of the economy are weak.

**The Economy Under Mahathir**

Since becoming Prime Minister, Mahathir has been forced by the global recession to preside over a relatively poor economic performance by Malaysian standards. Real growth slipped to 6 percent in 1981 and to 4.6 percent last year, as inflation reached 9.6 percent.

Adverse international price developments, particularly for commodities, have robbed the Malaysian balance of payments of much of its luster. The international purchasing power of Malaysian exports—as measured by the terms of trade—has eroded by nearly one-third, undermining the mechanism that enabled Malaysia to expand the volume of imports more rapidly than the volume of exports during most of the 1970s. Only manufactured exports—mostly electronics goods and semiconductors—have displayed much resilience during the global slowdown. Despite a good production performance, commodity export earnings have plummeted across the board, except for crude oil.

To offset the effects of weak export earnings, Malaysia has become one the most aggressive foreign borrowers among Asian LDCs. Kuala Lumpur borrowed a record \$2.5 billion last year. Credits signed included loans from official creditors—such as the World Bank, the International Monetary Fund, and the Asian Development Bank—and the full range of commercial credit facilities, including: a \$1.1 billion loan syndication, \$525 million in floating rate notes, credits that took special advantage of British tax law, and suppliers credits from a variety of Japanese and American firms. Despite the increase in borrowing,

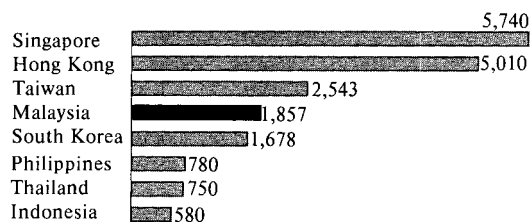
Secret

**Figure 1**  
**Malaysia, ASEAN, and the Asian**  
**NICs: A Comparison**

Note scale change

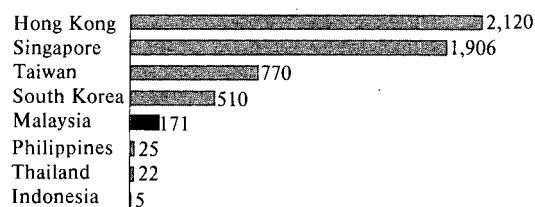
Output per Capita, 1982

US \$



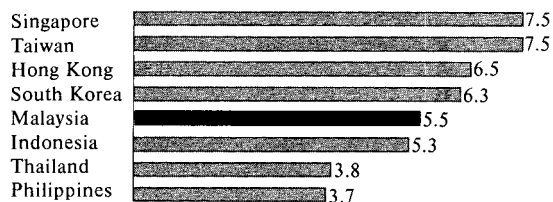
Manufactured Exports per Capita, 1982

US \$



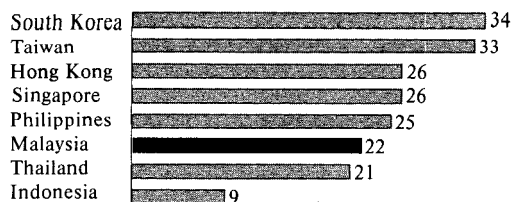
Per Capita Growth, 1970-80

Percent



Manufacture Share of Output, 1982

Percent



Kuala Lumpur has continued to garner extremely favorable terms on foreign loans from commercial bankers, with maturities among the longest (10 years) and interest rate spreads among the lowest (three-eighths percentage point over LIBOR) among Asian borrowers.

Domestically, Kuala Lumpur has tightened its fiscal belt. After expansionary spending ballooned the budget deficit to \$4.2 billion in fiscal 1982—17 percent of GNP—Kuala Lumpur instituted a program of fiscal austerity last October. The Ministry of Finance announced that expenditures would be reduced to 10 percent less than official budget allocations for the remainder of the calendar year and instituted similar cuts in 1983 spending. Cutbacks in development spending, especially in defense and education, have been especially deep, and formally sacrosanct programs designed to promote ethnic Malay interests have begun to be affected. Nonetheless, government spending is expected to equal about 42 percent of GNP this year—a very high ratio by Asian standards.

In an effort to increase both foreign exchange earnings and domestic revenues, Kuala Lumpur has abandoned its conservative oil-production policy and boosted oil output and cut prices when necessary to boost exports. Last year, oil production averaged 303,000 b/d, up from 258,000 b/d in 1981, and reached 326,000 b/d in December. Kuala Lumpur increased estimates of both oil and gas reserves to justify the new policy and matched OPEC price reductions early this year to maintain market share.

#### Mahathir's Emerging Economic Game Plan

Mahathir's economic policy thus far emphasizes heavy industry, resource-based development, government financial assistance, and joint ventures in sectors where private businesses appear reluctant to invest. He is advocating greater local control of national resources, and touts Japan and South Korea as role models for growth strategy.

Secret

Secret

---

**Mahathir and the New Economic Policy**

Kuala Lumpur embarked on the new economic policy (NEP) in the early 1970s with the twin objectives of eradicating poverty and restructuring employment and corporate equity in favor of the ethnic Malays. Instituted after serious racial rioting in the capital in 1969, the NEP is largely a collection of investment laws designed to assure 30-percent ownership of the corporate sector for the ethnic Malays by 1990 while limiting foreign ownership to no more than 30 percent. As of 1971 the Malays held 4.3 percent, about half in the form of government trusts, and foreigners held nearly two-thirds. [ ]

Mahathir's political career shows that he is more intimately linked to the NEP than previous Malaysian prime ministers. The institutional instruments for implementing the NEP are largely Mahathir's own creations, dating from the late 1970s, when he was Deputy Prime Minister and Minister of Heavy Industry. The Malay national trust, for example, Permodalan Nasional Berhad (PNB), was created to hold equity for ethnic Malays to accomplish the goals of the NEP without disrupting domestic investment unnecessarily. The government-owned Bank Bumiputra, a subsidiary of PNB, is a financial institution designed to finance government and quasi-government firms, partly by facilitating foreign loan syndications, and has become one of the largest commercial banks in Asia. [ ]

In addition, Mahathir has been the driving force behind Bank Islam Malaysia, an Islamic financial institution created to promote real estate development and finance investment and inventories for Bumiputra (Malay) firms. The bank, one-third owned by the government, will adhere to Islamic law by neither paying nor charging interest. Instead, it will attract deposits with a profit-sharing plan and "lease" rather than "finance" capital equipment. [ ] 25X1

Deputy Prime Minister Musa Hitam has also long been associated with the goals of the NEP. He was Minister of Primary Industries in the early 1970s and successfully used the Association of Natural Rubber Producing Countries (formed in 1970) to generate an international price stabilization scheme for rubber. The scheme is administered from Kuala Lumpur by the International Natural Rubber Organization. [ ] 25X1

Critics say that the NEP is responsible for stifling private-sector initiative. As part of the NEP, an investment law known as the Investment Coordination Act produced a sharp drop in domestic manufacturing investment and an aversion to risk among the predominantly ethnic Chinese entrepreneurial class. Although the intent of the law was to produce economic benefits for the ethnic Malay, the share of Malays employed in manufacturing remained essentially unchanged between 1968 and 1978, at about one-third the manufacturing work force. [ ] 25X1 25X1

**Emphasis on Heavy Manufacturing.** According to US Embassy officials, Mahathir believes capital-intensive development based on import substitution is the best course for Malaysia in an era of labor shortages, rising protectionism in industrialized countries, and increasing demands by indigenous groups to develop several economically depressed regions within Malaysia. As Minister of Heavy Industry, in 1980 Mahathir created the Heavy Industry Corporation of Malaysia (HICOM) to accelerate industrial development through joint ventures with the private sector and foreign investors. An ambitious list of projects, many

scheduled for HICOM development, forms the backbone of the government's industrialization strategy and has provided the impetus behind much of the government's foreign borrowing since Mahathir assumed the premiership. [ ] 25X1

Nationalism, rather than profits, appears to be the driving force behind much of the heavy industry program. Critics contend that the \$1 billion Sabah

Secret

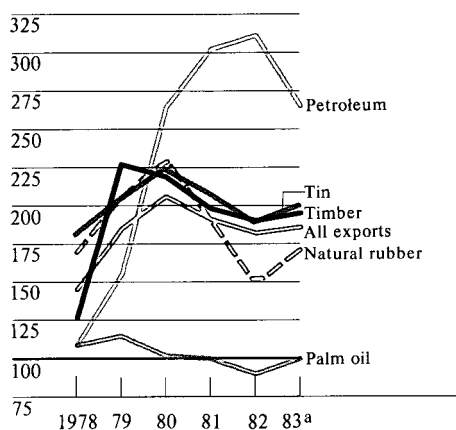
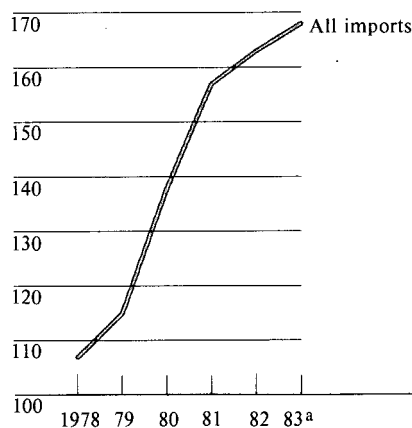
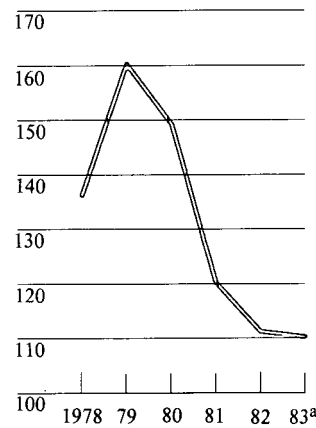


Secret

**Figure 2**  
**Malaysia: Terms of Trade Developments**

Index: 1975=100

Note scale change

**Export Prices**<sup>a</sup> Estimated.**Import Prices****Terms of Trade**

589868 6-83

industrialization program—intended by the government to develop portions of economically backward Borneo—contains several low-return projects along with financially viable energy development. Private financial analysts, however, point to plans to produce a Malaysian car as the prime example of Mahathir's disregard for profits. HICOM and Mitsubishi established a joint venture company early this year to begin building a front-wheel drive compact beginning in 1985, with production targeted to reach 100,000 units by 1990. Financial analysts believe the 100,000 unit rate will be barely at the break-even level. US Embassy officials, moreover, believe the domestic auto industry already contains too many firms, forcing individual plants to operate below capacity. The Prime Minister has admitted openly that the project cannot be justified on economic grounds and intends to ensure its financial viability by raising tariffs on imported cars.

During the past several months, government officials have begun to refer to the nation's heavy industrial strategy as "Malaysia, Incorporated," which we believe reflects new thinking on the role of government

in the predominantly private enterprise economy. According to government officials, the approach is to include streamlining the state enterprise sector through the divestiture of inefficient firms and establishing joint ventures with private companies in high-priority sectors of the economy. In addition, Kuala Lumpur intends to revise regulations in order to give selected domestic private firms a competitive advantage over foreigners.

**The "Look East" Campaign.** Mahathir wants to pattern Malaysian development on the South Korean and Japanese models—an approach he calls the "Look East" policy. The game plan includes increased use of suppliers credits from Japan and South Korea, emulation of their development planning institutions, and acquisition of Japanese and Korean manufacturing technologies through such means as joint ventures and training for Malaysian workers.

25X1

25X1

25X1

25X1

Secret

**Table 1**  
**Malaysia: Balance-of-Payments Summary**

*Million US \$*

	1979	1980	1981	1982 <sup>a</sup>	1983 <sup>b</sup>
<b>Current account</b>	<b>987</b>	<b>-362</b>	<b>-2,911</b>	<b>-3,708</b>	<b>-3,180</b>
<b>Merchandise trade</b>	<b>3,017</b>	<b>2,255</b>	<b>-330</b>	<b>-1,049</b>	<b>-480</b>
Exports (f.o.b.)	10,994	12,868	11,092	11,301	11,920
Of which:					
Petroleum	1,913	3,053	2,979	3,188	2,800
LNG	0	0	0	0	400
Natural rubber	2,038	2,108	1,598	1,191	1,400
Tin	1,053	1,144	921	664	700
Timber	1,915	1,814	1,506	1,057	1,200
Oil palm	1,123	1,189	1,222	1,182	1,100
Manufactures	2,180	2,789	2,177	2,200	2,400
Imports (f.o.b.)	7,977	10,613	11,422	12,350	12,400
Of which:					
Capital goods	2,324	3,262	3,371	4,050	3,700
Raw materials	3,711	5,139	5,466	5,685	5,700
Of which:					
Petroleum	574	858	877	903	800
<b>Services and transfers</b>	<b>-2,030</b>	<b>-2,617</b>	<b>-2,581</b>	<b>-2,659</b>	<b>-2,700</b>
Of which:					
Interest payments	344	449	634	1,132	1,042
<b>Capital account (net)</b>	<b>-315</b>	<b>834</b>	<b>2,622</b>	<b>3,378</b>	<b>2,880</b>
Of which:					
Direct investment	767	865	2,448	850	700
<b>Overall balance</b>	<b>672</b>	<b>472</b>	<b>-289</b>	<b>-330</b>	<b>-300</b>
International reserves	3,915	4,387	4,098	3,768	3,468

<sup>a</sup> Estimated.

<sup>b</sup> Projected.

Mahathir attempted to give the campaign some momentum when he made a well-publicized trip to Tokyo in January 1983 that resulted in a Japanese commitment of \$225 million in concessional credits. Japanese Prime Minister Nakasone furthered the "Look East" policy by granting Malaysia one of the largest increases in bilateral aid among the five ASEAN countries during his tour of the ASEAN states in April and May, Nakasone also expressed personal support for the "Look East" campaign, urging the Japanese business community to become

more active in Malaysia and to take greater advantage of joint venture opportunities. In addition, according to press reports, 120 Malaysian students are scheduled to begin studies in Japan as part of a long-term commitment to infuse the Malaysian work force with Japanese work ethics and technical expertise. Nonetheless, the campaign has produced relatively

Secret

**Table 2**  
**Malaysia: Survey of Heavy Industrial Projects**

Project	Estimated Cost	Remarks
Sabah industrialization program	\$1 billion	\$580 million in industrial plants; \$425 million energy development. Japanese participation in most projects. Critics say that, except for the energy projects, the program is very risky.
Pulp and paper plant	NA	
Sponge iron plant	NA	Planned 700,000-ton-per-year capacity.
Methanol plant	\$350 million	Planned 2,000-ton-per-day capacity.
Gas grid	\$207 million	Contract tendered. Support for industrial complex.
Power station		Accompanies gas grid.
Malacca refinery	\$1 billion	Planned 120,000-b/d capacity. On hold as of mid-April 1983 because of the global oil glut.
Pelabuhan Kelang Thermal Power Station	\$610 million	Under construction. Support for Malaysia's "electronics valley."
Integrated Steel Complex, including sponge iron plant—Trengganu	\$500 million; \$200 million	HICOM; Japanese joint venture: Nippon Steel
Hydroelectric development of Sarawak, including Batang Ai Dam	\$300 million	Under construction.
Penang port expansion	\$200-300 million	Status unknown.
Pulau Lumut port expansion (Selangor state)	\$200-300 million	Status unknown.
Cold Rolling Steel Mill	\$250 million	Japanese joint venture. Domestic market may not support it.
National rail upgrade	\$3 billion	Japanese Government funding feasibility study. Long-term project necessary to develop manufacturing potential and replace depreciating plant.
Cement plant program	NA	Expansion at Kedah. Letter of intent signed with Japanese firms. Progress likely to be slow.
Kuala Lumpur rapid transit	\$1.3 billion	On hold.
Coal conversion center	NA	Not yet under way.
ASEAN Urea-Ammonia Plant at Bintulu, Sarawak	\$220 million	Construction scheduled for this year. Will export to regional market.
Engineering Support Service Complex	\$200-300 million	Status unknown.
Underwater electrical transmission lines from Sabah to the peninsula	\$3.2 billion	Not yet under way. Cost may prove prohibitive.
Malaysian car venture	\$430 million	Joint venture between HICOM and Mitsubishi. Groundbreaking this summer. High tariffs required ensure viability.

little in new bilateral cooperation thus far, and according to US Embassy officials, most of Mahathir's Western-educated Cabinet and the bureaucracy regard the campaign with skepticism—if not scorn.

**Control Over National Resources.** In a move to establish local control over domestic natural resources, Kuala Lumpur has acquired majority interests in a number of foreign owned corporations doing

business in Malaysia. To date most of the government's targets have been British firms controlling large reserves of rubber and oil palm. In August 1981, for example, PNB acquired Guthrie Estates by purchasing large blocks of private shares on the London

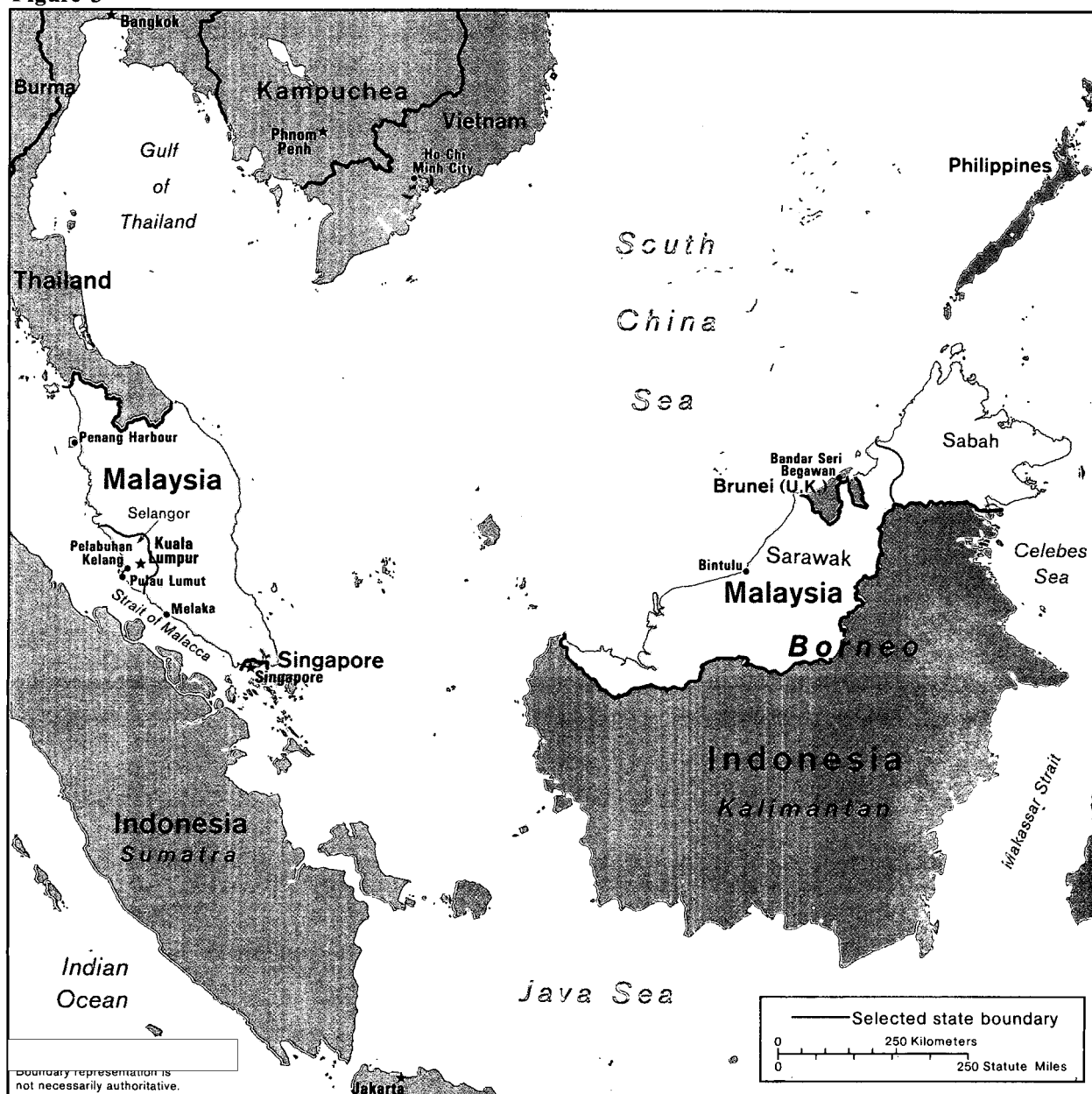
Secret

25X1

25X1

Secret

Figure 3



634543 (A02385) 6-83

Exchange in one day. In mid-1982 the government used a similar approach to acquire the Harrison-Crosfield Estates.

Mahathir also has taken several steps to enable indigenous business interests to become more actively involved in oil production and exploration. An exploration- and production-sharing agreement signed in

November 1982 (the first in two years) required that French-owned Elf Aquitaine take on Petronas Carigali, the exploration arm of the state oil company, as a joint partner along with two private Malaysian firms. This move has already payed dividends for the government. Petronas Carigali made its first gas strike last year.

Secret

Secret

**Moves on the International Front**

Mahathir's outspoken views on the global economic order have frequently been confrontational. In a speech to the Nonaligned Movement summit in New Delhi last March, he chastised Western economic policies for creating "the global economic crisis" while "deliberately manipulating commodity prices through antiquated marketing systems." The US General Services Administration drew special fire for "releasing stockpiled commodities in periods where market prices have fallen." Mahathir has also accused Western governments of disregarding the General Agreement on Tariffs and Trade and refusing to implement international shipping agreements that would allow LDCs to carry more freight on their own ships. [redacted]

**Tilting Against International Commodity Agreements.** Although preaching against manipulation, Malaysia has been the lead actor in efforts to fix tin and rubber prices. In April 1983 Kuala Lumpur took the lead in establishing the Association of Tin Producing Countries (ATPC) after over a year of hard lobbying with fellow tin producers Australia, Bolivia, Zaire, Nigeria, Thailand, and Indonesia. The Association is the outcome of Kuala Lumpur's efforts beginning in late 1981 to replace the Fifth International Tin Agreement when it expired in mid-1982 with a producers' organization. In addition to pushing the cartel, a variety of evidence—including large spot market purchases and reports by industry sources—point to tin market intervention by private Malaysian interests designed to boost international prices. The intervention campaign at a minimum had government financial support, because the firm that conducted the operation, the Malaysian Mining Corporation, is owned by PNB.<sup>1</sup> [redacted]

<sup>1</sup> In the aftermath of the ratification of the Sixth International Tin Agreement last year by producer and consumer countries (save for the United States), however, we believe the new ATPC will supplement, rather than supplant, the International Tin Agreement pricing mechanism. Other tin exporters have balked at Kuala Lumpur's insistence that the ATPC manage an independent buffer stock and establish its own export controls, and we believe that the new organization will do little more than work at improving marketing. Mahathir's chief dividend from the campaign against the International Tin Agreement appears to have been to assuage politically powerful domestic tin mining interests, mostly ethnic Chinese. [redacted]

**Prime Minister Mahathir on GSA Stockpile Sales and the London Metals Exchange**

*Quotes from an interview published in the Business Times, a Malaysian commercial newspaper, on 12 February 1983:*

**On GSA—**

The recent release of stockpiled tin at a time when prices are depressed is an act which is not becoming of a nation that is many, many times richer than Malaysia. It represents a substantial sum to them, but if they regard it as substantial, we regard it as colossal. They are hurting us more than it could ever help them. Whether it is a battle [between consumers and producers] is irrelevant. The fact is they know it will hurt us. [redacted]

25X1  
25X1**On the international tin market and the London Metals Exchange—**

I regard the London [Metals] Exchange as a cartel. It has no tin to speak of. All it does is control the price of the market irrespective of the cost of production. It is an exclusive club in which we have no chance of belonging, much less of influencing the price. They make money whether the price goes up or down, while our people and our country are suffering. I can't stand this situation. [redacted]

25X1

Kuala Lumpur's moves on the international tin front closely parallel its efforts to control the international price of natural rubber. Under the auspices of the Association of Natural Rubber Producing Countries (ANRPC), Kuala Lumpur began urging private Malaysian interests last October to withhold 129,000 tons of supplies from the international market (half the ANRPC total) over a six-month period in an effort to bid up international prices. The campaign died a peaceful death at the end of March 1983, however, and we believe the scheme succeeded in withholding at most 30,000 tons from the market, hardly enough to influence international prices. Nonetheless, as with the tin intervention scheme, Mahathir succeeded in

25X1

25X1

Secret

Secret

persuading a key domestic political constituency that he was protecting their interests. Two million Malaysians—out of a total population of 15 million—depend on the rubber industry as the primary source of income. [REDACTED]

### Debate and Confrontation

Domestic economic analysts have already begun a lively debate on economic strategy choices for the rest of the decade. Research published by Malaysia's leading academic economists argues that the era of effortless growth and large trade surpluses has ended, and that the country should lower its sights during the 1980s. This perception is based on their analysis that industrial economies will grow more slowly during the 1980s than during the 1970s, while rising protectionism will further curb the expansion in world trade. Malaysian academic research also argues that growing competition among LDCs in international capital markets will make foreign loans increasingly expensive. Because Malaysia does not enjoy a competitive advantage in heavy industry, the academics conclude that "the costs of inward-looking, import-substitution based industrialization is simply too high," and likely to produce growing trade deficits. The government, therefore, should settle for lower growth with a greater emphasis on redistributing income. [REDACTED]

For their part, most government officials criticize the academic research as "overdrawn pessimism." The Central Bank's April 1983 annual report agrees that the economy has become too dependent on commodity exports and oil revenues as mainstays of development but argues that with proper policy adjustments, growth and development prospects during the 1980s are bright. The Bank believes that rapid government expansion during the last several years has created an overly cautious private sector that is more averse to risk than private sectors in most LDCs, while rapidly expanding Malaysia's imports of raw materials and capital goods. The Bank, however, advocates a joint public- and private-sector effort to develop four sectors of the economy: construction, high-technology manufacturing, food production, and the replanting of rubber and log areas. This promises to reinforce Mahathir's emphasis on "Malaysia, Incorporated," in our judgment. [REDACTED]

In any case, the Prime Minister is taking charge of economic policy to ensure that his economic game plan will prevail. Mahathir and Deputy Prime Minister Musa Hitam, for example, have assumed control of economic policy at the expense of formerly influential technocrats with alternate views on policy, such as Finance Minister Tengku Razaleigh, a political rival of Musa's. Mahathir accused Razaleigh early this year of expanding Bank Bumiputra by ignoring the Bank's original purpose—to implement the NEP. A financial scandal this year involving the bank's investments in several shaky Hong Kong real estate development corporations promises to accelerate the centralization of economic decision making by weakening Razaleigh further. [REDACTED]

### Outlook

Whatever Mahathir does, however, we believe the Malaysian economy still has some breathing room before government economic policies inflict lasting damage on Malaysia's external accounts and growth performance. Even though Malaysia's 1982 foreign borrowing offensive raised the outstanding public foreign debt by one-third, for example, the repayment schedule is well structured, and we believe Kuala Lumpur could continue borrowing aggressively for several years before encountering any repayment difficulty. In addition, Malaysia has the capacity to boost production of several commodities such as sawn logs and timber to take advantage of firming demand in industrial countries, and international prices for some raw materials such as rubber have already begun to firm. [REDACTED]

Combined with these factors, relatively bright prospects for the energy sector should partly insulate the government budget and the balance of payments from the effects of slower growth in industrial countries. Petronas has the capacity to boost production in the short term by 30,000 to 50,000 b/d without damaging fields. Furthermore, the relatively high level of oil exploration activity bodes well for Kuala Lumpur's ability to expand production as planned to 360,000

Secret

Secret

**Table 3**  
**Malaysia: Foreign Debt and Debt Service**

Million US \$

	1979	1980	1981	1982 <sup>a</sup>	1983 <sup>b</sup>
<b>Outstanding debt <sup>c</sup></b>	<b>4,244</b>	<b>4,831</b>	<b>6,803</b>	<b>9,866</b>	<b>12,746</b>
Medium and long term	3,511	3,924	5,627	8,006	10,946
Short term	733	907	1,176	1,866	1,800
<b>Debt service</b>	<b>827</b>	<b>706</b>	<b>972</b>	<b>2,109</b>	<b>2,062</b>
Amortization	483	255	338	977	1,020
Interest	344	449	634	1,132	1,042

<sup>a</sup> Estimated.<sup>b</sup> Projected.<sup>c</sup> All maturities.

b/d on a sustained basis through at least 1985. As for LNG, Petronas finished completion of the \$1.6 billion Bintulu LNG facility in Sarawak last December. Although technical difficulties prohibited full operation after initial shipments to Japan in January 1983, Malaysian and Japanese authorities concluded a 20-year pricing agreement last March, and shipments this year should earn about \$400 million. Under the agreement, exports of LNG to Japan are expected to earn revenues of \$1.5 billion annually. [ ]

Nonetheless, time is running out for growth based on primary commodity exports and oil. Malaysia will have difficulty expanding volumes of natural rubber and oil palm exports on a sustained basis, given the virtual complete cultivation of the Malay peninsula (half Malaysia's cultivated land is rubber), insufficient replanting, and aging plantations. Furthermore, tin reserves are nearing depletion and the quality of reserves is declining. As for petroleum, lower prices resulting from the international oil glut will cost Malaysia \$400 million in export earnings annually assuming the OPEC benchmark remains at \$29 per barrel. [ ]

As the flow of earnings from these resources slowly winds down during the next several years, several developments would provide advance warning that Mahathir's growth strategy is not working, thereby

increasing Malaysian sensitivity to the commodity policies of the United States and making Washington a convenient target for criticism:

- A sharp decline in private domestic investment from the 10 to 12 percent of GNP recorded in the late 1970s.
- A decline in foreign investment in the export-oriented sector of Malaysian industry. Including oil, this reached \$850 million in 1982.
- Increased foreign borrowing to promote industrial development at the expense of equity participation.
- Large equity injections by the government into bumiputra (Malay) organizations such as PNB.
- Continued merchandise trade deficits and a growing foreign debt despite a recovery in export prices. In previous rebounds from global recession, Kuala Lumpur lowered the level of the outstanding foreign debt as exports recovered.
- Production well below capacity from Malaysia's showcase heavy industry projects once they come on stream.

25X1

25X1

25X1

Secret

Secret

- Resort to increasing oil production beyond sustainable production levels to meet government revenue or balance-of-payments needs.
- Increases in already high tariffs to protect Malaysian manufacturing interests from foreign competition in the domestic market.
- The introduction of foreign exchange controls to shore up the balance of payments. Kuala Lumpur has already considered—and for now dismissed—this move.
- An increasing tendency to overvalue the exchange rate in order to depress the local cost of imported capital goods and raw materials for the heavy industry sector.
- Increasing resort to barter deals as a way of reducing pressures on the merchandise trade account.

**US Interests.** The United States has many reasons to monitor Malaysia's economic progress and Kuala Lumpur's conduct of economic policy during the next several years. US investment in Malaysia, at \$2.4 billion, is exceeded in ASEAN only by US investment in Indonesia and Singapore. It is potentially vulnerable because the government has yet to achieve its objective of redistributing wealth from foreigners and ethnic Chinese to the ethnic Malay. Increasing Malay equity could mean moves against this investment or restricting new investment by foreigners. Bilateral trade, which exceeded \$3 billion in 1982, is potentially vulnerable to changes in Malaysian trade policy. Furthermore, Malaysia is an active participant in major international commodity agreements, such as the Sixth International Tin Agreement and the International Natural Rubber Organization, to which the United States is also a party.

Malaysian nationalism and domestic political maneuvering will continue to place Kuala Lumpur and Washington at loggerheads during the next several years. Kuala Lumpur, for example, along with several other Southeast Asian governments, remains interested in exerting greater control over the marketing of its exports and has experimented with barter trade arrangements that are likely to favor Japanese firms at

the expense of US firms. The government has completed only one barter deal thus far—an exchange of Malaysian rubber for Mexican cocoa beans—but reaped political dividends that may spur it to initiate others. In our judgment, the first deal enabled the government to demonstrate its commitment to small holders' interests, promoted Malaysian trading companies that arranged the deal, and avoided the Western commodity exchanges that Mahathir despises.

Although Mahathir has moved recently to moderate the tone of his criticism of GSA stockpile operations, Kuala Lumpur's interests will continue to be contrary to Washington's because the country is the world's largest producer of tin and rubber. As it is, Kuala Lumpur views the ATPC and the ANRPC as counterweights to GSA's stockpile operations. The government, in our judgment, will continue to try in years ahead to strengthen the influence of these organizations and at the same time to criticize Washington's international commodity policies.

At present, the first international forum in which conflicting US and Malaysian interests are scheduled to be articulated is this month's UNCTAD VI conference in Belgrade. Although we have no unique intelligence on Kuala Lumpur's plans for the conference, Mahathir's views on international commodity issues and the GATT rules are well known and likely to surface as part of Kuala Lumpur's position on the international economic order. In addition, Kuala Lumpur would like to develop the Common Fund—the generalized system for moderating international commodity price fluctuations—into an instrument better able to promote LDC interests.

25X1

25X1  
25X1

25X1

25X1

Secret



**Secret**

**Secret**